mists and the Supreme Court generally agree that predatory pricing is unlikely to succeed because there is little guarantee of successful recoupment, because rivals can also incur losses in anticipation of future profits, and because new entrants will appear if prices are raised after the existing competitors have exited the industry.[90] Moreover, it is difficult in practice to distinguish low competitive prices from predatory prices and to distinguish low earnings from predatory losses.[91]

The scenario of cross-subsidization and predatory pricing grows increasingly implausible when one considers that the interLATA and equipment markets the RBOC would enter have multiple incumbent suppliers with substantial capacity. In the interLATA market particularly, any attempt by an RBOC at predatory pricing would be futile because AT&T, MCI, and Sprint all have substantial capacity. Furthermore, the durability and expanding transmission capacity of fiber-optic cable would make it impossible for an RBOC to restrict industry output and raise prices above incremental costs during the recoupment phase of the predation scenario. Even in the unlikely event that an RBOC could drive one of the three large interexchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier would remain intact, ready for another firm to buy the capacity at a distress sale and immediately undercut the RBOC's noncompetitive prices. In short, an RBOC engaging in predatory pricing in the interLATA market could not expect to recoup its investment in sales made below incremental cost.

Even if one were to accept the predatory pricing argument, the connection made to the possibility of cross-subsidization is fundamentally flawed. If indeed an RBOC believed that it could enter a line of business profitably by initially incurring losses and then eliminating rivals and recouping profits, it could certainly do so by raising the requisite funds from investors. Through the normal functioning of the capital markets, investors will fund a business that is anticipated to be profitable, and cross-subsidies from one line of business to another are not needed. The view that an RBOC would cross-subsidize what would otherwise be a profitable business venture is therefore incorrect, because it is ignores the willingness of investors to fund the venture and thereby share in its returns.

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90. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 113 S. Ct. 2578 (1993); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986).

91. *See* BORK, *supra* note 70, at 144-155. For a survey of industrial organization models of predation, see Janusz A. Ordover & Garth Saloner, *Predation, Monopolization and Antitrust*, *in* 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 537 (Richard Schmalensee & Robert D. Willig eds., 1989)

D. *Competition in the Local Exchange Has Reduced the Profits With Which the RBOC Could Cross-Subsidize Other Businesses*

This Article has already stated that there is no economic incentive for an RBOC to cross-subsidize entry into other lines of business, whether or not the other businesses are expected to be profitable. Even if one were to believe that such incentives existed, any concerns should be allayed by the growing competition in the local loop. The significant level of competition in the local loop reduces or eliminates the RBOC's economic profits that could be diverted to other activities. This does not mean that the RBOCs are not currently profitable. The accounting profits earned by the RBOCs may include a return to their shareholders for the cost of capital. Rather, the RBOCs' economic profits, which represent earnings above the cost of capital and other costs, are controlled by the actions of actual and potential competitors. Furthermore, the RBOCs face regulatory controls on prices or rates of return that further limit their profits.

The presence of competition in local telecommunications markets, moreover, will eventually eliminate any cross-subsidies that governmental authorities have built into the existing regulated rate structure, such as the subsidization of residential customers by business customers.[92] If competitors are as efficient as the RBOCs, then the RBOC cannot set the price for any service at a level above the stand-alone costs of providing that service. If an RBOC attempted to do so, a competitor could profitably enter that market and provide the service on a stand-alone basis or in conjunction with other services. If the competitor is more efficient than the RBOC, which is certainly possible given the rapid pace of technological advances in telecommunications, the RBOC cannot price its services at or above the efficient stand-alone costs.

E. *The RBOCs Are Unlikely to Use Other Lines of Business to Shelter Income*

Another variant of the cross-subsidy argument asserts that if the line-of-business restrictions were lifted, an RBOC would use cross-subsidies to shelter income from the regulated local loop by transferring it to its unregulated equipment business, by setting above-market transfer prices for its self-manufactured equipment. In states in which the RBOC is regulated using price-caps or other incentive-based regulations, there is no incentive for such income transfers to take place, as the RBOC's earnings are not controlled. In states that still use rate-of-return regulation, various controls can prevent such income

92. On the elimination of cross-subsidies by competition in contestable markets, see BAUMOL ET AL., *supra* note 18, at 202.

transfers. States that have not yet done so could adopt incentive-based regulations. In addition, the states could apply equal access and competitive bidding regulations, for example mandating that the RBOC obtain competitive bids for equipment, thereby forcing it to bid against other equipment suppliers.

Due to the minimum efficient scale of manufacturing such sophisticated telecommunications equipment as central office switches, it is unlikely that an RBOC would find it profitable to produce only enough equipment to satisfy its own needs. The RBOC's need to sell equipment to unaffiliated third parties would therefore provide regulators an objective measure of the competitive price for such equipment. In states with rate-of-return regulation, regulators could readily observe whether the RBOC's internal transfer price for the same equipment exceeded the market price. Regulators could also observe the competing prices of other manufacturers as further evidence of the market value of such equipment.

Finally, an RBOC cannot use income transfers to shelter income, because such transfers would raise the costs of providing local exchange services above competitive levels. The RBOC would then lose customers to existing and potential competitors in the local loop. Active competition in the local loop requires an RBOC to control its costs, which would be inconsistent with above-market transfer prices for equipment and other services.

V. Eliminating the MFJ's Line-of-Business Restrictions Would Enhance Economic Efficiency and Serve the Public Interest

Entry of the RBOCs into the provision of interLATA services and the manufacture of telecommunications equipment would enhance competition in those markets. The line-of-business restrictions are regulatory barriers to entry that protect existing firms in the interLATA and equipment markets. Thus, for the RBOCs the line-of-business restrictions are incumbent burdens that not only restrict the competitiveness of the RBOCs in the local loop, but also give an advantage to new entrants in that market who can exploit a broader range of technologies in their service offerings and design of local networks. Allowing the RBOCs to enter the interLATA and equipment markets would enhance efficiency and stimulate innovation.

A. *RBOC Provision of InterLATA Services*

Allowing the RBOCs to enter the interLATA market would enhance economic efficiency in at least four ways. First, there are likely to be efficiency gains from the joint provision of access and interexchange services that arise from the use of common inputs, such as switching facilities. AT&T's

multi-billion-dollar acquisition of McCaw Cellular, as well as MCI's intention to integrate into the local telecommunications market, imply that the companies expect such efficiency gains to be substantial. These kinds of gains from vertical integration are called "economies of sequence."[93] The RBOCs' entry into the interLATA market would allow them to exploit any potential economies of sequence between either local exchange and interLATA services or between intraLATA and interLATA services. To deny the RBOCs entry into the interLATA market would be to deny consumers the savings from the cost efficiencies that such a combination would entail.

Second, to the extent that joint production yields economies of sequence, effective competition against vertically integrated firms in interexchange services, primarily AT&T-McCaw and MCI, may require a rival to be similarly vertically integrated. If the MFJ's line-of-business restrictions were eliminated, an RBOC could not only pursue alliances and resale arrangements with other carriers in the interLATA market, but could also extend its existing network for intraLATA toll services to provide interLATA service within its region. The result of such an extension would be enhanced competition in interexchange services.

Third, the RBOCs bring considerable technical and business expertise to the provision of interexchange services, which should serve to enhance efficiency in the interLATA segment of the market. The RBOCs possess technical and management experience in operating large telecommunications networks. In particular, with more than twice the fiber miles of the interexchange carriers, the RBOCs have technological expertise in fiber-optic transmission, which is the backbone of the interexchange system.[94]

Fourth, if the RBOCs were allowed to offer interLATA services, those that chose to do so would be able to apply their technological experience to research and development. The RBOCs bring experience in switching, providing access to long-distance services, and operating telecommunications networks. Each of these skills can be applied to innovation in interexchange services. Since access, switching, and transmission technologies continue to evolve, multiple research approaches are desirable. Continuing to forbid the RBOCs from providing interLATA services would therefore deny consumers some of the dynamic efficiencies that result from rivalry in technological innovation.

Continuing to bar the RBOCs' entry into interLATA services would impede the achievement of cost efficiencies, reduce the dynamic efficiencies from innovation, and deprive consumers of the benefits of increased competi

93. SPULBER, *supra* note 4, at 118-20.

94. In 1992, the RBOCs had 4,881,327 fiber miles, as compared with 2,412,100 fiber miles for all of the interexchange carriers. KRAUSHAAR, *supra* note 63, at 6, 15.

tion. Clearly, it is in the public interest to eliminate this line-of-business restriction. The interexchange market is substantial. Total toll service revenues of the long-distance carriers exceeded fifty-five billion dollars in 1991.[95] The market's size alone is sufficient to emphasize the public interest in opening the market to formidable competitors possessing highly specialized technological expertise. Increased domestic competition will create efficient and innovative companies. This can be expected to enhance the competitive position of American companies in the large international telecommunications market.

Long-distance telecommunications services are also closely related to the development of technology for the access, transmission, and switching facilities required for the so-called information superhighway. These interconnecting telecommunications networks are expected to improve the productivity and competitiveness of American industry and provide a variety of consumer benefits.[96] Continuing to bar the RBOCs from entering the interLATA market, however, could reduce the industry's speed and effectiveness in creating these superhighways.

B. *RBOC Manufacture of Telecommunications Equipment*

Eliminating the line-of-business restriction for equipment manufacturing would also enhance economic efficiency. Entry into equipment manufacturing would allow the RBOCs to exploit their knowledge of the characteristics of the local exchange and to produce equipment that addresses needs that the RBOCs are uniquely able to discern. The RBOCs bring long experience from building and operating the local exchange that would be useful in equipment manufacturing, particularly in the areas of central-office switching and in transmission equipment. Given their experience in fiber-optic transmission, the RBOCs could also contribute to the market for fiber-optic equipment.

As with interLATA services, entry into equipment manufacturing by the RBOCs would enhance dynamic efficiency. The RBOCs that entered the equipment manufacturing industry would be able to apply their technological experience to research and development. As this Article has already emphasized in the context of the interLATA restrictions, because rapid technological change continues to occur in the telecommunications industry, rivalry among

95. FEDERAL COMMUNICATIONS COMM'N, STATISTICS OF COMMUNICATIONS COMMON CARRIERS 6 (1991-92 ed.).

96. See NATIONAL TELECOMMUNICATIONS AND INFO. ADMIN., U.S. DEP'T OF COMMERCE, 20/20 VISION: THE DEVELOPMENT OF A NATIONAL INFORMATION INFRASTRUCTURE (1994), for discussions of the National Information Infrastructure and the "Information Superhighway."

firms in their research and development efforts is desirable. This is equally true regarding telecommunications equipment.

Because the RBOCs' entry into equipment manufacturing could be expected to yield dynamic efficiencies from innovation, as well as benefits from increased competition, it is in the public interest to eliminate this line-of-business restriction. The increased sales of American producers in the international market for telecommunications equipment could improve the United States' balance of trade. In addition, by their entry into equipment manufacturing, the RBOCs could contribute to the development of switching and transmission technology crucial for building information superhighways. It is therefore clear that eliminating the MFJ's line-of-business restriction on equipment manufacturing would advance the public interest.

Conclusion

There is no economic basis for continuing to forbid the RBOCs from providing interLATA services and manufacturing telecommunications equipment. The main arguments in support of the MFJ's line-of-business restrictions no longer apply to local exchange telecommunications. First, as a consequence of technological change and the transformation of the telecommunications industry that has been occurring since the MFJ, an RBOC's technology in the local exchange no longer exhibits the natural monopoly property. Second, as a result of technological change and industry transformation since the MFJ, the RBOCs no longer benefit from any significant entry barriers. Third, an RBOC could not unfairly leverage its market position in the local exchange into other markets. Fourth, an RBOC could not employ cross-subsidies from local service to achieve competitive advantages when entering other lines of business. In short, the arguments for continuing the line-of-business restrictions are no longer consistent with industry conditions and technology.

At the same time, the line-of-business restrictions reduce competition and deter innovation. As entrants in the interLATA and equipment markets, the RBOCs would likely be able to exploit economies of scope and sequence. The result would be an improvement in consumer welfare through lower costs and more vigorous competition in these markets. In a dynamic sense, such entry by the RBOCs would further benefit consumers by enabling the RBOCs to apply their specialized knowledge to the research and development of a broader spectrum of telecommunications products and services.

It is open to question whether the MFJ's line-of-business restrictions benefited consumers a decade ago. Today, they surely do not. The restrictions sacrifice competition, efficiency, and innovation while attempting to prevent

conduct that is already prohibited by economic forces. The line-of-business restrictions should be eliminated.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers;	)	
Treatment of Video Dialtone Services	)	
Under Price Cap Regulation	)	

NYNEX COMMENTS

The NYNEX Telephone Companies[1] ("NYNEX") file these Comments in response to the Commission's Third Further Notice of Proposed Rulemaking ("3d FNPRM") released September 21, 1995, in the above-captioned matter.

I. INTRODUCTION AND NYNEX POSITION

The Commission's Second Report and Order ("2d R&O") in this matter (which accompanies the 3d FNPRM) requires LECs to segregate video dialtone ("VDT") costs and revenues from those for telephone service for purposes of the sharing and low-end adjustment mechanisms once the LEC's provision of VDT exceeds a de minimis threshold.[2] The 3d FNPRM seeks comment on the specific level for the de minimis threshold as well as on procedures for allocating costs to the VDT basket if and when a LEC exceeds the threshold.[3]

It is NYNEX's position that the threshold should be set no lower than the amount of dedicated interstate VDT investment that would reduce the LEC overall interstate rate of

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1 The NYNEX Telephone Companies are New England Telephone and Telegraph Company and New York Telephone Company.

2 2d R&O at ¶ 1.

3 3d FNPRM at ¶¶ 39-42.

return by 25 basis points. If and when that threshold is reached, costs should be apportioned to the VDT basket using the approach in the FCC's price cap new services test, i.e. apportion no more than VDT direct costs plus allocated overhead costs reflected in pricing.

II. THE THRESHOLD FOR REMOVING VDT FROM SHARING AND LOW-END ADJUSTMENT CALCULATIONS SHOULD BE NO LOWER THAN THE AMOUNT OF DEDICATED VDT INVESTMENT THAT WOULD REDUCE LEC OVERALL RATE OF RETURN BY 25 BASIS POINTS

By way of background, in the VDT Recon. Order,[4] the Commission directed LECs to establish subsidiary accounting records consistent with the Part 32 Uniform System of Accounts in order to segregate VDT-related costs and revenues from those for telephone service. The Commission also required LECs authorized to provide VDT to file summaries of these subsidiary accounting records with the Commission on a quarterly basis. The Commission delegated authority to the Chief, Common Carrier Bureau to determine the content and format of the VDT subsidiary records and quarterly reports.[5]

The Commission indicates in its 2d R&O that in order to address its "concern regarding the possibility of cross-subsidization of LEC video dialtone service," it will exclude VDT costs and revenues from the calculation of LEC interstate earnings for sharing and low-end adjustment purposes once VDT costs exceed a certain threshold.[6] The

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[4] Telephone Company - Cable Television Cross-Ownership Rules, CC Docket No. 87-266, 10 FCC Rcd. 244, ¶ 173 (1994).

[5] Id. On April 3, 1995, the Bureau's Accounting and Audits Division issued RAO Letter 25 (10 FCC Rcd. 6008), which sets forth specific guidelines on the requirements for accounting classifications, subsidiary records, and amendments to cost allocation manuals for LECs that receive Section 214 authorization to provide VDT. On September 29, 1995, the Chief, Common Carrier Bureau released a Memorandum Opinion and Order adopting and implementing requirements for an ARMIS quarterly report that will contain wholly dedicated and shared VDT costs captured in subsidiary accounting records; and an expanded fourth quarter ARMIS report that will contain VDT cost and revenue data disaggregated by regulated and nonregulated classifications and by jurisdictional categories. Reporting Requirements On Video Dialtone Costs And Jurisdictional Separations For Local Exchange Carriers Offering Video Dialtone Services, DA 95-2036, AAD No. 95-59 ("AAD 95-59 Order").

[6] 2d R&O at ¶ 35.

Commission proposes to base that threshold on the data carriers are required to submit under RAO 25:

> Using the RAO Letter 25 data, the threshold could be set at the amount of dedicated video dialtone investment that would reduce the LEC overall rate of return by a specified amount, such [as] 10 or 25 basis points, for example.[7]

NYNEX agrees with the Commission's suggestion regarding use of 25 basis points. That approach to determining the threshold will effectively balance the Commission's public policy objectives of avoiding unnecessary administrative burdens and ensuring that potentially low initial VDT earnings will not significantly reduce overall LEC earnings which would potentially reduce sharing obligations.[8]

Use of dedicated VDT investment in determining the threshold is reasonable since such investment amounts under RAO 25 will be readily obtainable with a minimum of potential controversy from the LEC's ARMIS fourth quarter report. In addition, use of 25 basis points in calculating the threshold is supported by FCC precedent concerning the rate of return buffer zone for triggering earnings refund obligations. Under previous rules, the Commission prescribed an enforcement buffer of 25 basis points above the authorized rate of return, such that earnings within the buffer were deemed not significant enough to trigger refund obligations.[9] Indeed, prior to 1987 the FCC applied an enforcement buffer of 50 basis points.[10]

III. ONCE THE THRESHOLD IS REACHED, COSTS SHOULD BE APPORTIONED TO THE VDT BASKET USING THE APPROACH IN THE COMMISSION'S PRICE CAP NEW SERVICES TEST

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[7] 3d FNPRM at ¶¶ 39-40.

[8] 2d R&O at ¶ 35.

[9] See MCI Telecommunications Corp. v. FCC, No. 93-1191, Slip Opinion at p. 6 (D.C. Cir. Aug. 1, 1995) (discussing regulatory history of FCC rate of return prescriptions and refund rules).

[10] See id. at p. 4

The Commission invites comment on an approach for apportioning costs to the VDT basket for purposes of sharing and low-end adjustments once the threshold has been passed in the case of LECs that select an X-factor with sharing and low-end adjustments for telephony. The Commission suggests that it "could allocate costs to the video dialtone basket using the approach in the new services test applied in the tariff review process for setting video dialtone rates ... ."[11]

NYNEX agrees with this suggestion and believes two main policy goals should guide the Commission's decision on this issue. First, the purpose of removing VDT costs and revenue from sharing/low-end adjustment calculations is to guard against cross-subsidy of VDT.[12] Second, the Commission should provide for the use of existing data sources as opposed to imposing new regulatory requirements and administrative burdens.

NYNEX offers a proposal here which meets these policy goals through reliance upon the Commission's existing price cap new services test and the required ARMIS quarterly reports on VDT.[13] The appropriate cost amounts to exclude from the sharing/low end adjustment mechanisms are all direct costs wholly dedicated to VDT plus the VDT portion of shared investment and associated plant related expenses. To the extent that shared overheads are reflected in VDT prices, they may also be removed to calculate the interstate access rate of return.

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[11] 3d FNPRM at ¶ 41.

[12] 2d R&O at ¶ 35.

[13] We offered such a proposal in our preceding filings in this matter. See NYNEX Comments filed April 17, 1995, pp. 9-10; NYNEX Reply Comments filed May 17, 1995, pp. 8-9.

The Commission has already held that its price cap new services test applies to VDT. Under that test, initial VDT tariff rates must cover direct costs[14] and a reasonable allocation of overhead costs.[15] The Commission expressed the desire that VDT be a successful service contributing to the recovery of common costs. To this end, the Commission indicated that the price cap new service rules must not "saddle video dialtone with an unreasonable proportion of overheads and other common costs."[16]

It is important to recognize that as long as VDT rates cover incremental costs, there is no cross-subsidy of VDT, i.e. ratepayers for other services are not bearing any costs incurred as a result of VDT.[17] By definition, costs other than VDT incremental costs would exist in any case, i.e. independent of VDT, and there is no need for VDT rates to bear those non-incremental costs to preclude cross-subsidy.

As described above, the FCC has already made very clear that VDT rates under the price cap new services test must cover all VDT direct costs, which include all VDT incremental costs.[18] Indeed, by requiring that such VDT rates also cover allocated non-incremental costs, the FCC has more than ensured against cross-subsidy of VDT. To the same effect, use of the approach in the price cap new services test to calculate VDT costs

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[14] The Commission provided specific guidance in its VDT Recon. Order that VDT direct costs include "the costs and cost components associated with the primary plant investment that is used to provide the service," as well as a "reasonable allocation of other costs that are associated with shared plant used to provide video dialtone and other services .... [W]e do not anticipate accepting a 0% allocation of the common costs of shared plant as reasonable." Id. at ¶¶ 217-18. Besides such plant account-related costs, the Commission directed carriers "to treat costs in other accounts as direct costs if those costs are reasonably identifiable as incremental costs of video dialtone service." Id. at ¶ 219. See also RAO 25.

[15] The Commission indicated that "all costs not treated as direct costs are classified as overheads" and that it "would not anticipate accepting a 0% allocation of overhead as reasonable." VDT Recon. Order at ¶ 220.

[16] Id.

[17] See Separation Of Costs, CC Docket No. 86-111, 2 FCC Rcd. 1298, ¶ 109, notes 105 & 214.

[18] VDT Recon. Order at ¶¶ 217-19.

and revenue for removal from interstate regulated earnings calculations would more than ensure that the sharing and low-end adjustment mechanisms not produce cross-subsidy of VDT.[19]

These VDT cost and revenue amounts can be obtained pursuant to existing requirements and filings, i.e. the ARMIS fourth quarter report of VDT costs and revenue determined consistent with the VDT Recon. Order, RAO 25 and the Bureau's AAD 95-59 Order.[20] LEC VDT tariff filings following the price cap new services test will be on file with the Commission, containing full cost support delineating all direct costs and allocated overheads.

Any issues on the appropriateness of LECs' identification of VDT costs and revenue can be adequately resolved in the tariff review process and Commission review of ARMIS reports. Notably, since VDT is a nascent service which may be offered by carriers utilizing a variety of service features and network architectures, carriers may employ different cost allocation methodologies respecting VDT shared costs and overheads.[21] Given this reasonable potential diversity, the Commission has identified the tariff review

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[19] If a fully distributed cost allocation were used to remove VDT costs prior to calculation of interstate rate of return for purposes of sharing/low end adjustment mechanisms, more costs would be removed than would be covered under the Commission's pricing rules. There is no basis for apportioning more costs than required under the Commission's pricing rules which already go beyond preventing cross-subsidy. In fact, to do so may be viewed as granting an undue advantage to access ratepayers at the expense of emerging VDT services.

[20] The Commission states that under the new services approach, "if somewhat different cost allocation methodologies are used for a single LEC due, for example, to differences in technology for various video dialtone systems, we propose to weight the application of the different cost allocation methodologies in some manner." 3d FNPRM at ¶ 41. NYNEX believes that such a weighting approach will not be necessary inasmuch as the VDT ARMIS quarterly reports will capture in an additive manner the VDT costs for a LEC's discrete VDT systems.

[21] See VDT Recon. Order at ¶ 196; Video Dialtone Order, CC Docket No. 87-266, 7 FCC Rcd. 5781, ¶¶ 13, 34, 103, n.104; Bell Atlantic Telephone Companies Transmittal Nos. 741, 786, Order released June 9, 1995, ¶ 16 (CCB); 3d FNPRM at ¶ 41.

process for individual LECs as the appropriate vehicle for specifically addressing such matters.[22]

The use of these existing regulatory processes will help conserve administrative effort of the Commission and parties in attaining the Commission's policy goals. Overall, as the Commission previously found, the "existing rules adequately protect consumers against improper cross-subsidy and anti-competitive activity."[23]

IV. CONCLUSION

For the reasons stated, if a LEC's video dialtone dedicated investment corresponds to a threshold no lower than 25 basis points of interstate return, then the LEC should remove VDT costs and revenue from sharing/low end adjustment calculations. VDT costs to be removed should be determined using the approach in the FCC's price cap new services test, i.e. remove no more than VDT direct costs and allocated overheads reflected in pricing.

Respectfully submitted,

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Dated: October 27, 1995
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[22] VDT Recon. Order at ¶ 214; Bell Atlantic Telephone Companies, supra, ¶¶ 15-16.

[23] VDT Recon. Order at ¶ 166.